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C O N F I D E N T I A L SECTION 01 OF 02 MADRID 000654

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SUBJECT: UNEMPLOYMENT ZAPATERO'S MAJOR WORRY

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Classified By: CdA Arnold A. Chacon, for Reason 1.5(D)

1.(C) Summary: President Zapatero's main worry at present is Spain's faltering economy. The unemployment rate is over 18% and is headed for 20%. The perception that the economy is shedding jobs and that Zapatero does not know how to stop it has begun to take a political toll on his administration. In effect, jobs have become the line in the sand for this President: if he cannot convince the public that the unemployment news will improve in the medium term, his political base will begin to erode at an ever-increasing rate. The recession is expected to last longer than elsewhere in Europe, and the ruling party has suffered at the polls and in the legislature. The GOS has engaged in aggressive fiscal stimulus but must soon cut spending and increase taxes to head back towards the EU's deficit limit. The banking sector has been relatively healthy so far, but delinquency rates are rising and the GOS just established a rescue fund to help it deal with an expected wave of troubled institutions. The GOS does not face any more elections until Catalanian regional elections late next year, and the opposition's own problems have prevented it from taking more advantage. Nonetheless, the economy is expected to make the second half of 2010 uncomfortable for Zapatero and his government. End Summary.

Unemployment Rising, GDP Falling  
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2.(SBU) President Zapatero is facing sustained economic difficulties made even more unpleasant by the contrast with occasional encouraging signs in the U.S. and elsewhere in Europe. The worst of his problems is the unemployment rate, which at over 18% is the EU's highest. The rate is expected to top 20% later this year or early in 2010. While Spain's unemployment benefits are more generous than those in the U.S. and last for up to two years, benefits for those who lost their jobs at the start of the slowdown will soon begin to run out. Spain's troubles began before those of much of Europe when its housing boom lost steam in 2007, and its recession is expected to last longer than those in most of Europe. Many non-GOS observers do not expect growth to resume until 2011.

Inaccurate Optimism and Political Consequences  
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3.(C) Since the slowdown began, Zapatero and his ministers (with the occasional exception of the

now-departed Pedro Solbes) have consistently put optimistic spins on macroeconomic prospects. This tendency was most pronounced in the runup to the March 2008 elections but has continued since then, perhaps affected by Zapatero's apparent focus on the importance of consumer and investor confidence in sustaining economic activity. For almost two years now, every GOS economic growth prediction has proven overly optimistic and has soon been followed by less upbeat predictions from outside analysts. While the crisis has proven worse than almost anyone inside or outside government had expected, press reports suggest that this track record and Zapatero's continued expressions of optimism may have hurt his credibility. The PSOE lost seats in this month's European Parliament elections and lost control of Galicia's regional government in April elections. Even its good showing in the April Basque regional elections has complicated matters. The Basque chapters of the PSOE and the conservative opposition PP formed a coalition to take control of the regional government, the first time in the democratic era that the Basque Nationalist Party (PNV) did not control the government. In response, the PNV has stopped voting with the PSOE in the national legislature, forcing the PSOE into a difficult search for support from other small parties each time it hopes to get legislation passed. Clearly Zapatero realizes the political danger he is in. Every job lost is another small nail in his coffin. When he met with visiting Transportation Secretary LaHood in May, Zapatero emphasized the importance of keeping open Opel's plant in Zaragoza after the impending sale of Opel and asked the Secretary for help conveying that message to GM. At some point, Zapatero may face the unhappy prospect of ballooning the budget deficit to extend unemployment benefits. It will be a "damned if you do, damned if you don't" choice, since the opposition parties will excoriate him either way.

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#### Budget To Bring More Headaches

4.(SBU) When the economy began slowing in 2007, the GOS had a relatively low debt-to-GDP ratio of below 40%. That gave it room to respond with aggressive fiscal stimulus, through increased spending and tax cuts (along with the automatic stimuli of more unemployment benefit spending and lower tax revenues). This year's deficit is expected to approach 10% of GDP. However, the GOS will need to start to reduce its deficit if it is to reach the EU limit of 3% by 2012. Even if the GOS' growth predictions are accurate, it expects to need to reduce nonfinancial spending by 4.5% in 2010, which will force difficult and unpopular choices. On the revenue side, the GOS earlier this month hiked cigarette and fuel taxes and is said to face competing pressures from different parties to raise either the value-added tax or income taxes for 2010. To top it off, the GOS still has not been able to reach agreement with regional governments in a longrunning dispute over regional financing issues.

#### Worries over Banking Sector

5.(SBU) While conservative central bank regulation helped Spanish banks avoid the financial turmoil that hit much of the continent last year, the construction slump and overall economic slowdown have boosted delinquency rates. Banks and especially savings banks ("cajas") are expected to face increasing difficulty over the next year as delinquency rates continue to rise. The GOS last week established a rescue fund to help it encourage mergers and intervene in troubled institutions as needed (reftel). However, the restructuring that is expected to result is likely to eliminate tens of thousands of jobs in what is a relatively overbanked country.

6.(C) Despite the gloomy outlook, Zapatero does have a couple of things going for him. There are no national

elections until 2012 and no regional elections until Catalonia's in late 2010. Also, the opposition PP has been hurt by scandals and infighting and has not presented an attractive alternative. Spain's EU presidency in the first half of 2010 will give Zapatero a chance to be more of a player on the international stage, but the economy is likely to make for uncomfortable times between now and then.

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